Nos. 674 and 675

In the Supreme Court of the United States

OCTOBER TERM, 1946

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIDNEY S. MUNTER

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARL MUNTER

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Specification of errors to be urged	7
Summary of argument	8
Argument:	
The *Sansome* rule applies to a situation in which, upon the reorganization, new stockholders acquire for cash a stock interest in the successor corporation with consequent changes in the proportionate interest of the old stockholders in the enterprise	11
A. The basis of the *Sansome* rule is the prevention of tax avoidance through the device of a tax-free reorganization	11
B. The correctness of the statutory construction embodied in the *Sansome* rule has been confirmed by Congress in successive Revenue Acts and by Treasury Regulations having the force of law	18
C. The *Sansome* rule applies to this case	24
Conclusion	33
Appendix	34

CITATIONS

Cases:	
Baker v. *Commissioner*, 80 F. 2d 813	17, 32
Barnes v. *United States*, 22 F. Supp. 282	17, 30
Boehm v. *Commissioner*, 326 U. S. 287	22
Cable v. *Commissioner*, 102 F. 2d 377, certiorari denied, 308 U. S. 575	17
Campbell v. *United States*, 144 F. 2d 177	7, 13, 26, 29, 31
Commissioner v. *Sansome*, 60 F. 2d 931, certiorari denied, 287 U. S. 667	8, 9, 10, 11, 12, 18, 27, 28, 31, 32
Commissioner v. *Wheeler*, 324 U. S. 542, rehearing denied, 325 U. S. 892	14, 15, 24, 30
Corrigan v. *Commissioner*, 103 F. 2d 1010, certiorari denied, 308 U. S. 576	17
Crocker v. *Commissioner*, 29 B. T. A. 773	18, 32
Criswell Western Co. v. *Commissioner*, 155 F. 2d 433, certiorari denied, October 14, 1946	24

733398.3. 47—1

Cases—Continued	Page
Douglas v. *Cominissioner*, 322 U. S. 275	22
Fain v. *Commissioner*, 76 F. 2d 1008, certiorari denied, 296 U. S. 588	17
Geordav Enterprises v. *Commissioner*, 126 F. 2d 384	17
Harter v. *Helvering*, 79 F. 2d 12	17, 32
Helvering v. *Minnesota Tea Co.*, 296 U. S. 378	26
Helvering v. *Winmill*, 305 U. S. 79	22
Mandel v. *Commissioner*, 5 T. C. 684	18, 24, 30
McClintic, Estate of, v. *Commissioner*, 47 B. T. A. 188	18, 30
Murchison's Estate v. *Commissioner*, 76 F. 2d 641	16, 18, 31
National Sanitary Co. v. *Commissioner*, decided February 10, 1947	17
Putnam v. *United States*, 149 F. 2d 721	16, 24, 29, 30, 32
Reed Drug Co. v. *Commissioner*, 130 F. 2d 288	17, 24, 33
Riverside Cement Co. v. *Rogan*, 59 F. Supp. 401	18
Robinette v. *Commissioner*, 148 F. 2d 513	17, 24
Taft v. *Bowers*, 278 U. S. 470	29
Taft v. *Commissioner*, 304 U. S. 351	22
United States v. *Kauffmann*, 62 F. 2d 1045	17, 18
United States v. *Phellis*, 257 U. S. 156	29
Statutes:	
Internal Revenue Code:	
Sec. 22 (26 U. S. C. 1940 ed., Sec. 22)	38
Sec. 115 (26 U. S. C. 1940 ed., Sec. 115)	9, 14, 25, 30, 31, 38
Sec. 718 (26 U. S. C. 1940 ed., Sec. 718)	23
Revenue Act of 1921, c. 136, 42 Stat. 227:	
Sec. 201	14
Sec. 202	14
Revenue Act of 1924, c. 234, 43 Stat. 253, Sec. 203	12
Revenue Act of 1926, c. 27, 44 Stat. 9, Sec. 203	12
Revenue Act of 1928, c. 852, 45 Stat. 791:	
Sec. 111	34
Sec. 112	12, 14, 24, 25, 35
Sec. 113	29
Revenue Act of 1932, c. 209, 47 Stat. 169, Sec. 112	12
Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 115	13
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 112	25
Sec. 115	13, 18, 21
Revenue Act of 1938, c. 289, 52 Stat. 447, Sec. 115	13, 21
Second Revenue Act of 1940, c. 757, 54 Stat. 974, Sec. 501 (26 U. S. C. 1940 ed., Sec. 718)	23
Miscellaneous:	
H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940-2 Cum. Bull. 548, 555)	24
H. Rep. No. 708, 72nd Cong., 1st Sess., p. 26 (1939-1 Cum. Bull. (Part 2) 457, 471)	12

Miscellaneous—Continued

	Page
H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940-2 Cum. Bull. 496, 526)	23, 24
S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18-19 (1939-1 Cum. Bull. (Part 2) 779, 792)	22
S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25 (1940-2 Cum. Bull. 528, 546-547)	23, 24, 26
S. Rep. No. 2156, 74th Cong., 2d Sess., p. 19 (1939-1 Cum. Bull. (Part 2) 678, 690)	19, 26
T. D. 5299, 1943-1 Cum. Bull. 747	22, 30
T. D. 5304, 1943-1 Cum. Bull. 367	22
T. D. 5402, 1944 Cum. Bull. 229	22
Treasury Regulations 74, Art. 578	39
Treasury Regulations 94, Art. 115-11	20, 21, 26
Treasury Regulations 101, Art. 115-11	21
Treasury Regulations 103:	
Sec. 19.115-2	41
Sec. 19.115-11	9, 20, 21, 22, 26, 30, 42
Treasury Regulations 111, Sec. 29.115-11	21, 22

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OPINIONS BELOW

The opinion of the Tax Court (R. 20–29) is reported in 5 T. C. 108, and the opinion of the Circuit Court of Appeals (R. 41–46) is reported in 157 F. 2d 132.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on August 7, 1946 (R. 46–47). The

petition for writs of certiorari was filed on November 6, 1946 (R. 50), and was granted on December 16, 1946 (R. 49). The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the *Sansome* rule, under which a corporate distribution is deemed a dividend when it is made from earnings and profits of predecessor companies whose assets were acquired by the successor corporation in a tax-free reorganization, applies to a situation in which new stockholders, upon the reorganization, acquire, for cash, a stock interest in the successor corporation, with consequent change in the proportionate interest of the old stockholders in the enterprise.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are printed in the Appendix, *infra*, pp. 34–44.

STATEMENT

The facts in these cases, consolidated for hearing in the Tax Court (R. 20), were submitted upon a stipulation of facts (R. 8–19) which the Tax Court incorporated by reference as its findings of fact (R. 21) and summarized in its opinion (R. 21–29).

On March 21, 1940, each of the taxpayers purchased, at a price of $8 per share, 10,000 shares

of common stock of Crandall-McKenzie & Henderson, Inc. (usually referred to below as the "New Corporation"), a Pennsylvania corporation (R. 8–9). These shares were part of 38,922 shares of stock of the New Corporation issued and outstanding; there were in addition 11,078 shares of treasury stock (R. 9), thus totaling 50,000 shares. These 50,000 shares were all common stock and of the stated value of $1 per share and were all the capital shares that the New Corporation had issued from the date of its organization (R. 14).

On June 19, 1940, the New Corporation distributed to its common shareholders $35,166.25 in cash at the rate of $1.25 per share. Each taxpayer received $12,500 on the 10,000 shares held by him. (R. 9.)

The New Corporation had been organized on December 4, 1928 (R. 14), pursuant to an agreement with investment bankers (K. W. Todd & Company). (R. 21.) In exchange for 24,131 shares of its stock and $355,247.75 in cash, the New Corporation had acquired all the assets of two predecessor corporations, Crandall-McKenzie Company (usually referred to below as "Crandall"), and L. Henderson & Sons, Inc. (usually referred to below as "Henderson, Inc."). (R. 21.) All the assets of Henderson, Inc., one of the predecessor corporations, were acquired by the New Corporation solely in exchange for 9,524 shares of New Corporation stock (R. 21). While the acqui-

sition of the Crandall assets was accomplished by means of a complex series of transactions,[1] the

[1] The particulars of these transactions are as follows: O. McKenzie owned 842½ of the Crandall shares and A. E. Crandall owned the same number. (R. 21.) The agreement with the investment bankers on the one hand, and O. McKenzie as stockholder in Crandall, and L. Henderson as stockholder in the other predecessor corporation (Henderson, Inc.), on the other, provided that the latter would cause A. E. Crandall to sell to the New Corporation his 842½ shares for $300,000 (R. 21–22). However, Crandall opposed the consolidation and would neither sell his stock to the New Corporation nor exchange his stock for stock of the New Corporation, but he did sell his stock to O. McKenzie for $300,000 (R. 22). The New Corporation then purchased from O. McKenzie 1,685 shares of Crandall stock as a block (being the stock formerly owned by A. E. Crandall, together with the 842½ shares which O. McKenzie owned originally) for $300,000, and 12,181 shares of New Corporation stock (R. 22). By a modification of the plan of reorganization as originally adopted, Kapp and Brown, two other stockholders of Crandall, each owning 100 shares of its stock, exchanged their Crandall holdings for 1,213 shares of New Corporation stock, plus $15 in cash (R. 13), and each of them became an officer or employee of the new company. The New Corporation purchased 25 additional shares of Crandall (originally belonging to Ayers and Hasson) at $315.53 a share, for $7,888.25 (R. 11–12). Finally the New Corporation purchased the remaining 150 shares of Crandall stock, belonging to 104 stockholders, for $47,329.50 (R. 12–13).

In acquiring the assets of Henderson, Inc., the New Corporation issued 9,524 shares of its stock to L. Henderson and associates, stockholders of this predecessor corporation, in exchange for the 700 outstanding shares of Henderson, Inc. (R. 13–14).

The New Corporation, by means of the stock of each of the predecessor companies thus acquired, caused dissolution of the predecessor companies, and the assets of each, subject to liabilities, were transferred to the New Corporation (R. 12–13).

Tax Court found that, in substance, the assets of Crandall were acquired by the New Corporation for 14,607 shares of its capital stock and $355,247.75 in cash (R. 21). The acquisitions and distributions were as follows:

Crandall shares	From Crandall stockholders	For consideration of—	
		New Corporation shares	Cash
1,685	O. McKenzie	12,181	$300,000.00
240	Kapp and Brown	2,426	30.90
25	Ayers and Masson		7,888.25
150	104 stockholders		47,329.50
2,000		14,607	355,247.75

Thus 24,131 shares of the New Corporation and the cash were received by stockholders of the two predecessor corporations for their stock in the predecessor companies.

The remaining 25,869 shares of the total 50,000 shares were issued by the New Corporation to new interests for cash in the amount of approximately $489,893.92 (R. 21).

At the time of the acquisition of its assets by the New Corporation, Crandall had earnings and profits accumulated subsequent to March 1, 1913, of $329,267.95, and L. Henderson & Sons, Inc., had similar earnings and profits of $74,743.62, making a total of $404,011.57 earnings and profits (R. 21). It was stipulated (R. 9) that the New Corporation "had no earnings and profits accumulated from December 4, 1928 to December 31, 1939,

and it had no earnings or profits in its taxable year January 1, 1940 to December 31, 1940."

It was further stipulated (R. 14) that from December 4, 1928, the date of its organization, to December 31, 1939, the New Corporation "had aggregate earnings and profits of $401,470.07, made aggregate cash distributions to shareholders of $369,452.30, and acquired by purchase for cash 11,078 shares $1.00 par value of its own stock for $72,211.13", and that in 1940, it had a net loss of $37,252.47 and acquired by purchase for cash 12,805 shares of its own stock for $94,441.90.[2]

The Commissioner treated the cash distribution of $12,500 received by each of the taxpayers in 1940 from the New Corporation as a distribution of earnings or profits accumulated subsequent to March 1, 1913, and therefore taxable as an ordinary dividend (R. 22).

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[2] The stipulations described in this paragraph and in that immediately preceding may be inconsistent. Since there were earnings and profits of $401,470.07 and distributions of only $369,452.30, there may have been earnings of $32,017.77 which had not been distributed as of January 1, 1940. The New Corporation's purchase of 11,078 shares of its own stock for $72,211.13 in cash may not have affected these earnings. Neither the stipulation nor the Tax Court's findings indicate that these shares were cancelled or redeemed. The record does show that the New Corporation issued 50,000 shares upon its organization, no new shares were ever issued, and, on March 21, 1940, there were 11,078 shares of treasury stock outstanding (R. 8-9, 14). The Tax Court did not decide whether or not the purchase of these shares affected earnings or profits (R. 22, n. 1, R. 42, n. 3). This is an issue which the Tax Court should decide, if the case is remanded as suggested by the dissenting judge in the court below (R. 46).

The Tax Court sustained this determination (R. 20–27), one judge dissenting (R. 27–29). Holding that the New Corporation took the accumulated earnings and profits of the predecessor corporations as its earnings and profits, and that the identity of the interests of the stockholders of the predecessor corporation in the succeeding company was not the basis for the *Sansome* doctrine, it declined to follow the contrary holding of the court below in the first branch of its decision in *Campbell* v. *United States*, 144 F. 2d 177 (R. 25), and further concluded that the second ground of decision in the *Campbell* case was inapplicable to the instant record, since no cash distributions were made to Henderson stockholders and there was here no basis of fact to support a finding that Crandall's earnings and profits had been exhausted when distributions of cash were made to its stockholders (R. 26–27).

The court below, relying on the first ground of its prior decision in the *Campbell* case, reversed the Tax Court, Judge O'Connell dissenting (R. 44–46), (R. 41–44); the Court found it unnecessary to determine the applicability of the second ground of the *Campbell* decision (R. 42, n. 3, R. 43, n. 5).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the cash distribution made by the New Corporation to its stockholders was

not a dividend within the meaning of Section 115 (a) of the Internal Revenue Code.

2. In holding that, after a reorganization under Section 112 (i) (1) (A) of the Revenue Act of 1928, the earnings or profits of the two predecessor corporations did not become the earnings or profits of the distributing corporation.

3. In reversing the decision of the Tax Court.

SUMMARY OF ARGUMENT

A. In concluding that the earnings and profits of the old companies were transferred to the New Corporation as earnings and profits for tax purposes (and not, as the majority of the court below held, as capital), the Tax Court expressly relied upon the so-called *Sansomé* rule. This doctrine, as originally developed in *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, and as repeatedly recognized in subsequent cases, is a rule of statutory construction, that an exemption from taxation incident to a transfer in a tax-free reorganization implies a Congressional purpose that the earnings and profits of transferor companies should remain earnings and profits in the hands of acquiring companies for purposes of distribution to stockholders; its basis is to prevent tax avoidance by the device of a tax-free reorganization.

B. The *Sansome* rule is not only a well-settled judicial doctrine, repeatedly approved and ap-

plied by the courts, but it is, moreover, confirmed by statute and long standing Treasury Regulations, having the force of law. Congressional Committee Reports have repeatedly cited or stated the *Sansome* principle with approval as existing law. Section 115 (h) of the Internal Revenue Code and Section 19.115–11 of Treasury Regulations 103, having the force of law, here controlling and applicable, sanction the rule.

C. The only obstacle which the court below found to the application of the *Sansome* rule was the circumstance that, as an incident to the reorganization, new stockholders acquired, for cash, an interest in the New Corporation with a consequent change in the proportionate interest of the old stockholders in the enterprise. The court below erred in narrowly circumscribing the *Sansome* doctrine to cases where an identity of proprietary interest is maintained throughout the reorganization. The purpose of the *Sansome* rule is to prevent tax avoidance; the undistributed earnings of the predecessor corporations do not disappear and unless taken over, as such, by the new company, they escape proper taxation. These earnings are transferred tax-free as much, in the case where the identity of proprietary interest in the successor corporation differs from that of the predecessors, as where the identity of the proprietary interest remains unchanged; there is no more reason for them to escape taxation when

distributed by the transferee in one case than in the other, and the necessity of closing the door to this form of tax avoidance is equally present whether or not new capital has come into the enterprise. As in the *Sansome* case, the instant transaction is one which by mandate of statute is deemed not to break the continuity of corporate life despite the introduction of new capital. Certainly, once the statutory definition of continuity of corporate life provided by the reorganization provisions is abandoned as a basis for application of the *Sansome* rule, and a rigid standard of identity of proprietary interest substituted, the *Sansome* rule becomes so narrow as to be valueless for prevention of tax evasion since it would apply to relatively few reorganizations. On the other hand, if a test of substantial identity be substituted, the test becomes so vague as to be impracticable of administration. If the decision below is correct, it will be as difficult to draw the line between identity and non-identity as between those changes of form and substance which were the subject of controversy before there were reorganization statutes.

The distinction taken by the court below is not only in disagreement with other judicial authority, but it directly conflicts with the applicable statute and Regulations. These apply to all reorganizations in which gain is not recognized, not merely those in which identity of proprietary in-

terest is preserved; they do not recognize the limitation imposed upon the *Sansome* rule by the court below.

ARGUMENT

THE *SANSOME* RULE APPLIES TO A SITUATION IN WHICH, UPON THE REORGANIZATION, NEW STOCKHOLDERS ACQUIRE FOR CASH A STOCK INTEREST IN THE SUCCESSOR CORPORATION WITH CONSEQUENT CHANGES IN THE PROPORTIONATE INTEREST OF THE OLD STOCKHOLDERS IN THE ENTERPRISE

A. *The basis of the* Sansome *rule is the prevention of tax avoidance through the device of a tax-free reorganization.*—In concluding that the earnings and profits of the old companies, aggregating $404,011.57, were transferred to the New Corporation as its earnings and profits for tax purposes (and not, as the majority of the court below held, as capital), the Tax Court expressly relied upon the rule, first enunciated by Judge Learned Hand in *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667. There a newly organized corporation acquired in a tax-free reorganization the entire assets of another corporation subject to its liabilities; in return the new corporation transferred all of its stock to the stockholders of the predecessor in the same proportional interests as their stockholdings in the old company. The old company was then dissolved and the new company, after operating without net earnings, subsequently discontinued business and made distribution to its stockholders in liquidation. Under the Revenue Act of 1921,

controlling the *Sansome* case, a liquidating dividend was taxable as an ordinary dividend to the extent of the corporation's earnings. *Commissioner* v. *Sansome, supra,* p. 923. The Second Circuit Court of Appeals held that the earnings and profits of the predecessor company had been carried over, as such, into the new company as its earnings and profits, and, that, to the extent of these transferred earnings, the liquidation distribution by the new company was taxable to the stockholders of the new company as a dividend. This conclusion was reached even though the Revenue Act of 1921 did not contain any provision expressly dealing with this problem.[3]

[3] Section 203 (g) of the Revenue Act of 1924, c. 234, 43 Stat. 253, provides:

"The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reorganization, shall not be considered a distribution of earnings or profits within the meaning of subdivision (b) of section 201 for the purpose of determining the taxability of subsequent distributions by the corporation."

The provision was continued in effect in Section 203 (g) of the Revenue Act of 1926, c. 27, 44 Stat. 9, and Section 112 (h) of the Revenue Act of 1928, c. 852, 45 Stat. 791. In Section 112 (h) of the Revenue Act of 1932, c. 209, 47 Stat. 169, the phrase "if no gain to the distributee from the receipt of such stock or securities was recognized by law" was inserted before the phrase "shall not be considered". This amendment was prompted by the addition of Section 112 (k) under which certain exchanges, involving foreign corporations, would not be tax-free under Section 112 (h). See H. Rep. 708, 72nd Cong., 1st Sess.,

In his dissenting opinion in *Campbell* v. *United States*, 144 F. 2d 177 (C. C. A. 3d), Judge Jones aptly states the rationale of the *Sansome* doctine (p. 183):

> In so deciding, Judge Learned Hand, who spoke for the Court, said (60 F. 2d at page 933) that "what was not 'recognized' as a sale or disposition for the purpose of fixing gain or loss [i. e., the reorganization exchange], should [not] be 'recognized' as changing accumulated profits into capital * * *." As it was the intent of Congress, as evidenced by the Revenue Acts, to tax as dividends corporate distributions of earnings accumulated since February 28, 1913, manifestly, to accord such distributions freedom from taxation, when ultimately received by stockholders, merely because of coincidental bookkeeping attendant upon a successor corporation's acquisition of a predecessor's business and assets as the result of a reorganization, would be violative of the congressional intent. It necessarily foi-

p. 20 (1939-1 Cum. Bull. (Part 2) 457, 471). In the Revenue Act of 1934, c. 277, 48 Stat. 680, the provision was transferred from the exchange section to the dividend section and became Section 115 (h). It will be noted that under all of these statutes, the ineffectiveness of such a distribution to diminish earnings and profits was clearly prescribed only as to the distributing corporation. Section 115 (h) of the Revenue Acts of 1936 and 1938, discussed hereinafter, made it clear that the same rule applied as to subsequent distributions by any corporation involved in the reorganization.

> lowed, therefore, as a corollary, that the non-recognition of gain or loss allowed by the reorganization provision there involved (*See*. 202 (c) (2) of the Revenue Act of 1921) should, i.. the words of Judge Hand, "be read as a gloss upon section 201" (the taxable dividend definition of the Revenue Act of 1921). Accordingly, it was held in the *Sansome* case, 60 F. 2d at page 923), *as a matter of statutory construction*, "that a corporate reorganization which results in no 'gain or loss' under section 202 (c) (2) (42 Stat. 230) does not foll the company's life as continued venture ir der section 201, and that what were 'earni igs or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation."

Section 112 (b) (3) and (i) (1) (A) of the controlling Revenue Act of 1928 and Sections 115 (a) and (b) of the Internal Revenue Code (Appendix, *infra*, pp. 35, 37, 38–39), here involved, are substantially the same as Sections 202 (c) (2) and 201 (a) and (b) of the Revenue Act of 1921 dealt with in the *Sansome* case.

In *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892, this Court, citing with apparent approval the *Sansome* case, by analogous reasoning came to a similar conclusion with respect to the tax effect of tax-free transactions upon corporate gains and losses as reflected in corporate earnings and profits, saying:

> Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income-tax liability but shall be taken account of later. §§ 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits. Compare *Commissioner* v. *Sansome*, 60 F. 2d 931, and see Sen. Rep. No. 2156, 74th Cong., 2d Sess., p. 19; H. R. Rep. No. 2894, 76th Cong., 3d Sess., p. 41.

The circumstance that as a matter of bookkeeping practice, the predecessor's assets may be recorded as capital and not as earnings or profits in the successor's books is immaterial, for, as this Court further stated with respect to the analogous situation involved in the *Wheeler* case (p. 546):

> The taxpayers are insisting on using as a base for tax purposes a figure that in itself has no relation to taxation. It was no doubt permissible and perhaps the correct accounting, for determining earned surplus for dividends and such corporate purposes, for the corporation to set up its books on the market value of its property at the time of acquisition, which determined the value of the stock it issued. But "earnings and profits" in the tax sense, although it does not correspond exactly to taxable income,

> does not necessarily follow corporate accounting concepts either.

Indeed, so the First Circuit Court of Appeals has held in a factual situation requiring application of the *Sansome* rule. *Putnam* v. *United States*, 149 F. 2d 721, 726.

Thus, the *Sansome* doctrine, as originally developed, is a rule drawn from the relevant statutes to the effect that the exemption from taxation incident to a transfer in a tax-free reorganization implies a Congressional purpose to have the earnings and profits of the transferor companies remain earnings and profits in the hands of acquiring companies for the purpose of distributions to stockholders. The basis of the rule is the prevention of tax avoidance by the device of a tax-free reorganization. This was recognized by the Fifth Circuit Court of Appeals in one of the earliest of the many cases that have applied the *Sansome principle*, when it said in *Marchison's Estate* v. *Commissioner*, 76 F. 2d 641, 642, that:

> Unless the undistributed gains of the old business are taken over by the new as undivided profits distributable as dividends, they escape proper taxation

and it finds renewed expression in one of the most recent, where the First Circuit Court of Appeals said, in *Putnam* v. *United States*, *supra*, p. 726: "The purpose of the *Sansome* rule is to prevent tax evasion". This is also the reasoning

of Judge O'Connell, in his dissenting opinion in the court below (R. 45).[4]

The *Sansome* rule, shortly after its enunciation, was applied, in *United States* v. *Kauffmann*, 62 F. 2d 1045 (C. C. A. 9th), to ordinary (non-liquidating) dividends, such as the Commissioner seeks to tax in the instant case. In *Corrigan* v. *Commissioner*, 103 F. 2d 1010, certiorari denied, 308 U. S. 576, likewise involving the taxation of an ordinary dividend, distributed subsequent to a reorganization, the court below approved the *Sansome* rule by expressing its agreement with and following Second Circuit decisions in *Baker* v. *Commissioner*, 80 F. 2d 813, and *Cable* v. *Commissioner*, 102 F. 2d 977, certiorari denied, 308 U. S. 575, which had applied it. The *Sansome* principle has been repeatedly affirmed and approved in many decisions in addition to those already cited. *Fain* v. *Commissioner*, 76 F. 2d 1008 (C. C. A. 5th), certiorari denied, 296 U. S. 588; *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2d); *Geerday Enterprises* v. *Commissioner*, 126 F. 2d 384 (C. C. A. 4th); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th); *Robinette* v. *Commissioner*, 148 F. 2d 513 (C. C. A. 9th); *Barnes* v. *United States*, 22 F. Supp. 282 (E. D.

[4] The Sixth Circuit Court of Appeals has recently held the *Sansome* rule applicable under the Revenue Act of 1918. *National Sanitary Co.* v. *Commissioner*, decided February 10, 1947 (1947 C. C. H., ¶ 9163).

Pa.); *Riverside Cement Co.* v. *Rogan*, 59 F. Supp. 401 (S. D. Cal.); *Crocker* v. *Commissioner*, 29 B. T. A. 773; *Estate of McClintic* v. *Commissioner*, 47 B. T. A. 188; *Mandel* v. *Commissioner*, 5 T. C. 684.

B. *The correctness of the statutory construction embodied in the* Sansome *rule has been confirmed by Congress in successive Revenue Acts and by Treasury Regulations having the force of law.*—The *Sansome* rule is not only a well settled judicial doctrine, authorized by many court decisions over an extended period, but it is, moreover, confirmed by statute and long standing Treasury Regulations, having the force of law. The *Sansome* case was decided in 1932; the *Kauffman* case in 1933; and *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641 (C. C. A. 5th), in 1935. In framing the 1936 Revenue Act, the Senate Committee on Finance proposed Section 115 (h), quoted in the footnote,[5] in the form in

[5] Revenue Act of 1936, c. 690, 49 Stat. 1648:

"SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * * *

"(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—

"(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

"(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income

which it was eventually enacted. This proposal was not understood to change "existing law" (see note 3, *supra*, pp. 12–13), but was deemed desirable "in the interest of greater clarity", and it was specifically made applicable to distributions made before January 1, 1936. In recommending the amendment, the Finance Committee said (S. Rep. No. 2156, 74th Cong., 2d Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690)):

> SECTION 115 (H). EFFECT OF DISTRIBUTIONS ON EARNINGS AND PROFITS
>
> The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law, is a nontaxable stock dividend or a distribution of stock or securities in connection with a reorganization or other exchange, *on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.* This rule is stated only

to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

"As used in this subsection the term 'stock or securities' includes rights to acquire stock or securities."

> in part in section 115 (h) of the Revenue Act of 1934, and corresponding provisions of prior acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner* v. *Sansome*, 60 Fed. (2) 931; *U. S.* v. *Kauffman*, 62 Fed. (2) 1045; *Murcheson* v. *Comm.*, 76 Fed. (2) 641. While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interest of greater clarity. [Italics supplied.]

The italicized language of this Committee Report, which states the *Sansome* rule (as, indeed, the Committee explicitly notes), was carried over substantially verbatim into Treasury Regulations 94, promulgated under the Revenue Act of 1936, Art. 115–11, implementing the amended Section 115 (h) and other provisions of the 1936 Act. Thus, this article of the Regulations[6] makes clear that the *Sansome* rule is applicable in the case of reorganizations in which gain is not recognized in full, and makes explicit what is necessarily implied by Section 115 (h) of the statute, that non-taxable distributions which Section 115 (h) states are not "considered a distribution of

[6] This article is not quoted for the reason that, except for additions that have no materiality here (see footnote 7, *infra*, pp. 21–22), it is identical with Section 19.115–11 of Regulations 103 under the Internal Revenue Code, Appendix, *infra*, pp. 42–44.

earnings or profits of any corporation" do not, in the words of the Regulations, "diminish the earnings or profits of any corporation" and that they "remain intact and available for distribution" by the "corporation to which the earnings or profits are transferred upon such reorganization or other exchange". The Regulations further specify that this rule is applicable to such distributions made in any earlier year.

In Section 115 (h) of the Revenue Act of 1938, c. 289, 52 Stat. 447, the words "property or money" were added after the phrase "stock or securities" and these amendments also were made applicable to distributions made before the passage of that Act. Save for the change made necessary by this amendment, Article 115–11 of Treasury Regulations 94 has been continued without substantial change under subsequent Revenue Acts and the Internal Revenue Code controlling in the tax year here involved.[7] Section 115 (h)

[7] Treasury Regulations 101, under the Revenue Act of 1938, Art. 115–11; Treasury Regulations 103, under the Internal Revenue Code, Sec. 19.115–11, here applicable (Appendix, *infra*, pp. 42–44); and Treasury Regulations 111, under the Internal Revenue Code, Sec. 29.115–11, applicable to years beginning after December 31, 1941. Treasury Regulations 103, Sec. 19.115–11 and Treasury Regulations 111, Sec. 29.115–11, were amended, respectively, by T. D. 5299, 1943–1 Cum. Bull. 747, and T. D. 5304, 1943–1 Cum. Bull. 367, subsequent to the tax year here involved, which inserted imme-

of the Internal Revenue Code (Appendix, *infra*, p. 39), the statute here applicable, is substantially the same as Section 115 (h) of the Revenue Act of 1938.[8] On familiar principles, Treasury Regulations, long continued without substantial change, and applying to an unamended or substantially re-enacted statute, are deemed to have received Congressional approval and have the force of law. *Taft* v. *Commissioner*, 304 U. S. 351, 357; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Douglas* v. *Commissioner*, 322 U. S. 275, 281–282; *Bochm* v. *Commissioner*, 326 U. S. 287, 291–292.

Other reports of Congressional committees likewise recognize the *Sansome* rule as law. Thus, in recommending the amendment to the Internal Revenue Code which later, as Section 501 of the Second Revenue Act of 1940, added Section 115 (l) to the Code, and which defined the effect on corporate earnings and profits of gain or loss and of receipt of tax-free distributions, the House

diately after the [illegible] paragraph a new paragraph having no materiality here. See Treasury Regulations 103, Sec. 19.115–11 as amended, Appendix, *infra*, pp. 42–43. Treasury Regulations 111, Sec. 29.115–11 was further amended by T. D. 5402, 1944 Cum. Bull. 229, but the amendment is of no significance here.

[8] In proposing the 1938 amendment to the corresponding Section 115 (h) of the Revenue Act of 1938, the Senate Finance Committee again stated the *Sansome* rule as existing law. S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792).

Committee said (H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum. Bull. 496, 526)):

> Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome*, 60 F. (2d) 931, and following decisions, the rule effectuates the provisions of section 112.

The Senate Report quoted in the footnote,[9] without specifically naming the *Sansome* case, clearly restates the rule. "In recommending the provisions for computation of the excess-profits tax also contained in the Second Revenue Act of 1940, adding Section 718 (b) (3) to the Internal Revenue Code, these Committee Reports again accepted as established law the *Sansome* rule."[10]

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[9] S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25 (1940–2 Cum. Bull. 528, 546–547):

"Under various provisions of the Internal Revenue Code dealing with exchanges and liquidations, the transfer of the property by a corporation to another corporation results in the nonrecognition, in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. These principles are to be given full effect under section 501. The requirement of section 501 that there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee."

This, the court below recognized, in *Crossett Western Co.* v. *Commissioner*, 155 F. 2d 433, certiorari denied, October 14, 1946.

This Court and others have acknowledged the statutory sanction for the *Sansome* rule. *Commissioner* v. *Wheeler*, 324 U. S. 542, 546–547; *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288, 289 (C. C. A. 6th); *Robinette* v. *Commissioner*, 148 F. 2d 513, 516 (C. C. A. 9th); *Putnam* v. *United States*, 149 F. 2d 721, 726 (C. C. A. 1st); *Mandel* v. *Commissioner*, 5 T. C. 684, 690.

C. *The* Sansome *rule applies to this case.*—The court below agreed with the Tax Court that the transaction under which the New Corporation acquired all of the assets of the two old companies, Crandall and Henderson, Inc., constituted a reorganization under Section 112 (i) (1) (A) of the controlling Revenue Act of 1928 (Appendix, *infra*, p. 37) (R. 22–23, 43), that is—

> (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), * * *

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[10] H. Rep. No. 2894, *supra*, p. 25; S. Rep. No. 2114, *supra*, p. 14; H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940-2 Cum. Bull. 548, 555).

Under the reorganization plan, the participating stockholders of Henderson, Inc., exchanged their stock solely for stock in the New Corporation and stockholders of Crandall exchanged their stock for stock in the new company and money. As the Tax Court expressly held (R. 22–23) and the court below implied and assumed (R. 42), these exchanges were obviously tax-free to both of the predecessor corporations (see Section 112 (b) (4) and (d) of the Revenue Act of 1928; Appendix, *infra*, pp. 35, 36).[11]

[11] They were also tax-free to the stockholders of the predecessor corporations within the meaning and to the extent provided in Section 11. (b) (3) and (c) (1) of the Revenue Act of 1928. (Appendix, *infra*, p. 35.) The exchanges were necessarily tax-free as to the stockholders of Henderson, Inc., who received only stock of the new company, and the Tax Court assumed, in the absence of proof to the contrary, that the Crandall stockholders realized no gain.

Section 115 (b) of the Internal Revenue Code (Appendix, *infra*, p. 39) does not establish any specific rule where gain is recognized only to a limited degree as it is where "boot" is distributed. Under Section 112 (c) (1) and (2) of the Revenue Act of 1936 (as under the corresponding provisions of the Revenue Act of 1928), a stockholder realizing a gain from the receipt of "boot" and securities in exchange for securities in a reorganization is taxable on the gain to an amount not in excess of the "boot". Under Section 112 (c) (2) the *recognized* gain will be taxed as a dividend, if it has the effect of the distribution of a dividend. It seems obvious that the mere distribution of "boot" in a reorganization exchange does not prevent the application of the *Sansome* principle, and the Treasury Regulations recognize that the principle applies wherever the gain is not taxable in full. See

There having been a reorganization plan under Section 112 (i) (1) (A) and a substantial continuity of interest (*Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378), the situation was one which called for the application of the *Sansome* rule. However, the court below, in accordance with the first ground of its decision in the *Campbell* case, refused to apply that rule on the theory (R. 43–44) that it had no application where there was introduction of new capital with consequent changes in the proportionate interests of the old stockholders in the enterprise. It consequently held that neither the earnings of Henderson, Inc. nor the earnings of Crandall were transferred to the New Corporation. The Tax Court having declined to follow the *Campbell* case (R. 25), the court below reversed, holding "this case * * * squarely under the first exception in Campbell" (R. 43, n. 5), which "is still the law of this Circuit", and "controls the question under consideration" (R. 44). The decision below was rested solely on the lack of identity of proprietary inter-

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first paragraph of Article 115–11 of Regulations 94 and Sec. 19.115–11 of Regulations 103, *infra*, p. 42. Otherwise any cash distribution, however small, would permit the escape of large amounts of earnings and profits from tax as dividends. The excerpt from S. Rep. 2156, 74th Cong., 2d Sess., p. 19, quoted *supra*, pp. 19–20, shows that Congress thought the principle applied so long as the gain was not recognized in full. To the same effect is S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25, quoted in footnote 9, *supra*, p. 23.

ket, and the Government filed its petition for a writ of certiorari in order to secure a ruling by this Court as to whether the mere fact that new stockholders acquire for cash a stock interest in the successor corporation prevents the application of the *Sansome* rule.

In narrowly circumscribing the *Sansome* doctrine as it did, the court below erred. As pointed out in subpoint A, *supra*, pp. 11–18, and as expressed by the judges dissenting below and in the *Campbell* case, the authorities establish that the basis for the *Sansome* rule is prevention of tax avoidance by the device of a reorganization which is tax-free in whole or in part. The necessity for closing the door to this form of tax avoidance is equally present whether or not new capital has come into the enterprise. Unless the undistributed earnings and profits of the old corporations are taken over, as such, by the new, they escape proper taxation.

These "earnings do not disappear" (R. 45), and by force of the reorganization statute, they are transferred, tax-free as much in the case where the proprietary interest in the successor corporation differs from that in the predecessors as when the proprietary interest remains unchanged; there is no more reason for them to escape taxation, when distributed by the transferee, in one case than in the other. In the *Sansome* opinion, Judge Hand reasoned that Congress employed the reorganiza-

tion provisions to define certain transactions which (p. 933)—

> should not break the continuity of the corporate life, a troublesome question that the courts had beclouded by recourse to such vague alternatives as "form" and "substance," anodynes for the pains of reasoning. The effort was at least to narrow the limits of judicial inspiration. * * *.

This reasoning contradicts the essential argument of the *Campbell* opinion that an identity of proprietary interest motivated the *Sansome* decision. In this case too, the transaction is one which by mandate of statute is deemed not to break the continuity of corporate life despite the introduction of new capital, but the court below holds that the change in proprietary interests defeats the application of the *Sansome* rule. Certainly, once the statutory definition of continuity of corporate life provided by the reorganization provisions is abandoned as a basis for the application of the *Sansome* rule and a rigid standard of "identity of proprietary interest" substituted, the *Sansome* rule becomes so narrow as to be valueless for prevention of tax evasion since it would apply to relatively few reorganizations. On the other hand, if a test of substantial identity be substituted, the test becomes so vague as to be impracticable of administration. If the decision below is correct, it will be as difficult to draw the line between identity and non-identity as between those changes

of form and substance which were the subject of controversy before there were reorganization statutes. The approach suggested below, in the words of Judge Hand, must depend upon "judicial inspiration", whose limits in this connection the reorganization provisions were intended "at least to narrow."

The vital factor is not who receives earnings or profits, but that earnings or profits, which have been transferred tax-free on a reorganization, should not escape taxation upon a subsequent distribution. *Putnam* v. *United States*, 149 F. 2d 721, 722 (C. C. A. 1st). To tax the receipt of such a distribution as out of earnings and profits no more involves (*Campbell* v. *United States, supra*, pp. 180–181)—

> the contradictory concept of a corporation buying profits with money contributed by new stockholders, whereas profits by their nature must be realized from other transactions and may not themselves be acquired by purchase.

than does the undoubted right to tax a distribution to a stockholder from corporate profits, earned before he acquires his stock interest. *United States* v. *Phellis*, 257 U. S. 156, 171–172. Taxable income is not limited to increases which occur while the taxpayer owns the property. *Taft* v. *Bowers*, 278 U. S. 470, 484.[12]

[12] Nor does the cost basis fixed by statute (Section 113 (a) (7) of the Revenue Act of 1928) for assets acquired by the

As noted in subdivision B, *supra*, pp. 18–24, the rule here applicable is not founded solely on judicial interpretation; it possesses the additional sanction of statutory confirmation and of long standing Treasury Regulations, having the force of law. Neither Section 115 (h) of the Internal Revenue Code nor Section 19.115–11 of Treasury Regulations 103 confines the *Sansome* rule to the narrow limitations fixed by the court below. There is no suggestion of a limitation to cases where the identity of proprietary interests is preserved,[11] and there is no reason to doubt the validity of the Regulation. Cf. *Commissioner* v. *Wheeler*, 324 U. S. 542, rehearing denied, 325 U. S. 892.

Since the *Sansome* rule may no longer be considered solely a judicial doctrine, but is sanc-

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successor corporation affect the amount of earnings or profits acquired with the transfer of the predecessor's assets. See *Putnam* v. *United States*, 149 F. 2d 721, 726 (C. C. A. 1st).

[11] The Regulations further specify that these earnings or profits are available for distribution as dividends—

"by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange."

Where, in a tax-free reorganization, less than all of the assets of a predecessor company are transferred to the new company, the rule is that earnings and profits of the old company follow its assets proportionately in the hands of the transferee corporation. *Rogers* v. *United States*, 22 F. Supp. 282 (E. D. Pa.); *Estate of McClintic* v. *Commissioner*, 47 B. T. A. 188; *Mandel* v. *Commissioner*, 5 T. C. 684. See also, amendment to Treasury Regulations 103, Sec. 19.115–11 by T. D. 5299, 1943–1 Cum. Bull. 747, which, subsequent to tax year here involved, inserted a new paragraph immediately after the first paragraph (Appendix, *infra*, pp. 42–43).

tioned by statute and Regulations having the force of law, the over-literal argument made against it, based upon a reading of Section 115 (a) of the Internal Revenue Code (Appendix, *infra*, p. 38), that a dividend means a distribution "made by a corporation * * * out of *its* earnings or profits" (italics supplied), and that the earnings and profits here sought to be taxed are not *its*, but those of the predecessor corporations, properly held without validity in *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641, 642 (C. C. A. 5th), seems now immaterial. Cf. *Campbell* v. *United States*, 144 F. 2d 177, 179 (C. C. A. 3rd) and dissent of Judge Jones, 144 F. 2d at 183.

Moreover, a ground of distinction between the instant case and the *Campbell* case is present here for, as appears from subpoint B, *supra*, pp. 18–24, Section 115 (h) of the Internal Revenue Code and the Regulations under it (or their predecessor cognates) were not respectively enacted or promulgated until 1936, which was subsequent to the tax years (1933 and 1934) involved in the *Campbell* case. Accordingly, while we urge that the *Campbell* decision is, in any event, incorrect as a judicial interpretation of the *Sansome* rule of construction, the decision here, as it is was not there, is additionally governed by controlling statute and regulation. We conclude, therefore, that the difference indicated in the opinion below between the facts in the *Sansome* case and in this case is without material legal significance.

The distinction taken by the court below is in disagreement with other judicial authority; it conflicts with the decision of the First Circuit Court of Appeals in *Putnam* v. *United States*, 149 F. 2d 721. In that case the *Sansome* doctrine was applied although the old stockholders there "did not retain the same interest in the assets transferred which they had before". 149 F. 2d at 727. There the acquired corporation was already in existence at the time of the reorganization but this does not alter the fact that its stockholders and capital were new stockholders and new capital insofar as the acquiring company was concerned.[14]

It is true that in the *Putnam* case, the court said that the old stockholders "received a compensatory interest in the assets of" the new corporation "which they did not have before", and that, in that manner, "their proportionate proprietary interest was maintained." *Ibid.* But that can only mean that the stockholders of a predecessor corporation continued to have, *inter sese*, the same proportionate interests. Even if that be a relevant factor, it is equally true here.[15]

[14] In citing the *Campbell* case, the *Putnam* opinion, p. 726, refers only to the dissenting opinion of Judge Jones.

[15] The lower court recognized *Croker* v. *Commissioner*, 29 B. T. A. 773, as a conflicting authority in its *Campbell* opinion, 144 F. 2d at 180, although it sought to distinguish it in its opinion below (R. 44). See also *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2d); *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2d).

See also *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th).

CONCLUSION

The decision of the Circuit Court of Appeals for the Third Circuit should be reversed.

Respectfully submitted.

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MARCH 1947.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

(b) *Adjustment of basis.*—In computing the amount of gain or loss under subsection (a)—

(1) Proper adjustment shall be made for any expenditure, receipt, loss, or other item, properly chargeable to capital account, and

* * * * *

(3) In the case of stock the basis shall be diminshed by the amount of distributions previously made in respect of such stock, to the extent provided under the law applicable to the year in which the distribution was made.

(c) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(d) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the pur-

poses of this title, shall be determined under the provisions of section 112.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) *Exchanges solely in kind.*—

* * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * * *

(c) *Gain from exchanges not solely in kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsec-

tion but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(d) *Same—gain of corporation.*—If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan or reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

* * * * * *

(h) *Same—effect on future distributions.*—The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or stock or securities in a corporation a party to the reor-

ganization, shall not be considered a distribution of earnings or profits within the meaning of section 115 (b) for the purpose of determining the taxability of subsequent distributions by the corporation.

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

* * * * *

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) [as amended by Public Salary Tax Act of 1939, c. 59, 53 Stat. 574, Sec. 1] *General Definition.*—"Gross income" includes gains, profits, and income derived

from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently

accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(*h*) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 578. *Source of distribution of stock or securities.*—The general rule, provided in section 115 (b), that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to a distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, of its stock or securities or of stock or securities in a corporation a party to the reorganization. Such a distribution will not be considered a distribution of earnings or profits in determining the amount of earnings and profits accumulated since February 28, 1913, which are available for distribution and which under section 115 (b) must be distributed before earnings and profits accumulated before March 1, 1913, may be distributed exempt from tax.

Example: The X Corporation has a capital of $100,000, earnings and profits accumulated prior to March 1, 1913, of $25,000, and earnings and profits of $50,000 accumulated after February 28, 1913. It causes the organization of the Y Corporation, to which it transfers $50,000 of its assets in exchange for all of the stock of the Y Corporation. It then distributes the stock of the Y Corporation as a dividend to its shareholders. No gain to the shareholders from the receipt of this stock will be recognized under the provisions of section 112 (g) and article 576, nor will the distribution be considered a distribution of earnings or profits in determining the amount of earnings and profits accumulated since February 28, 1913, on hand for a subsequent distribution as a dividend.

The provisions of this article apply to

the case in which the X Corporation distributes the stock of the Y Corporation as a dividend, the case in which the X Corporation distributes the stock of the Y Corporation in retirement of a portion of the stock of the X Corporation, and the case in which the Y Corporation issues its stock direct to the shareholders of the X Corporation.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

> SEC. 19.115–2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. In determining the source of a distribution, consideration should be given *first,* to the earnings or profits of the taxable year; *second,* to the earnings or profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings or profits of that year; *third,* to the earnings or profits accumulated prior to March 1, 1913, only after all the earnings or profits of the taxable year and all the earnings or profits accumulated since February 28, 1913, have been distributed; and, *fourth,* to sources other than earnings or profits only after the earnings or profits have been distributed.
>
> * * * The portion of each such distribution which is not regarded as out of earnings or profits of the taxable year shall be considered a taxable dividend to the extent of the earnings or profits accumulated

since February 28, 1913, and available on the date of the distribution. In any case in which it is necessary to determine the amount of earnings or profits accumulated since February 28, 1913, and the actual earnings or profits to the date of a distribution within any taxable year (whether beginning before January 1, 1936, or, in the case of an operating deficit, on or after that date) cannot be shown, the earnings and profits for the year (or accounting period, if less than a year) in which the distribution was made shall be prorated to the date of the distribution not counting the date on which the distribution was made. * * *

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SEC. 19.115–11. [as amended by T. D. 5299, 1943–1 Cum. Bull. 747] *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

If a transaction described in the preceding paragraph has occurred, there shall be included in the accumulated earnings and profits of the transferee corporation as of

the day on which such transaction occurred the proportionate part of any earnings and profits of the transferor corporation accumulated as of such day and properly allocable to the transferee; and there shall be included in the current earnings and profits of the transferee for the taxable year of the transferee in which such transaction occurred the proportionate part of the earnings and profits of the transferor accumulated after the beginning of such taxable year and properly allocable to the transferee. The amount so included in the current earnings and profits of the transferee shall not exceed such proportionate part of the earnings and profits of the transferor accumulated as of the day on which such transaction occurred.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

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A distribution described in paragraph (1), * * * above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. * * *

For the purposes of this section, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.

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